Nos. 15,461 - 15,462

United States
COURT OF APPEALS
for the Ninth Circuit

L. H. PIERCE, Appellant

v.

UNITED STATES OF AMERICA, Appellee

UNITED STATES OF AMERICA, Appellant

v.

LENA L. PIERCE, Appellee

BRIEF FOR THE UNITED STATES

On Appeals from the Judgments of the United States District Court for the District of Oregon

Charles K. Rice,
Assistant Attorney General.

John N. Stull,
I. Henry Kutz,
Arthur I. Gould,
Attorneys,
Department of Justice,
Washington 25, D.C.

Clarence E. Luckey,
United States Attorney.

Edward J. Georgeff,
Assistant United States Attorney.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE., 8-28-57—45

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OPINION BELOW

The District Court rendered no opinion; its findings of fact and conclusions of law are to be found at R. 25-31.

JURISDICTION

These consolidated appeals involve federal income taxes, and taxpayers are respectively husband and wife. The taxes in dispute for the taxable year 1946 were returned and paid on or about March 15, 1947. (R. 17-18.) Claims for refund were filed on June 7, 1949 (R. 20-21), and no decision was rendered by the Commissioner within the six months the claims were filed nor at any date thereafter. Within the time provided in Section 3772 of the Internal Revenue Code of 1939 and on December 6, 1954, taxpayers brought actions in the Distric Court for recovery of taxes paid. (R. 3-8.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The judgments were respectively entered on October 29, 1956, in the case of L. H. Pierce in favor of the Government dismissing the complaint and in the case of his wife, Lena L. Pierce, in her favor in the amount of $1,553.55 with interest. (R. 31-33.) Within sixty days and on December 5, 1956, notices of appeals were filed by the Government and L. H. Pierce from the judgments respectively adverse to each. (R. 34-35.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether salary income received by a taxpayer for his services as a corporate official represents income attributable to the operation of a trade or business regularly carried on by him for purposes of computation of the net operating loss deduction within the meaning of

Section 122(d)(5) of the Internal Revenue Code of 1939.

2. Whether the nature of the income reported one-half separately by a husband and wife as community property income is determined for both as attributable to the operation of a trade or business by the activities of the husband who produced the income.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *   *   *

(s) [As added by Sec. 211(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 122 [As added by Sec. 211(b), Revenue Act of 1939, *supra;* and amended by Sec. 105(e), Revenue Act of 1942, c. 619, 56 Stat. 798; Sec. 215(a), Revenue Act of 1950, c. 994, 64 Stat. 906]. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—

(A) *Loss for Taxable Year Beginning Before 1950.*—If for any taxable year beginning after December 31, 1941, and before January

1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed—

(i) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and

(ii) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss and without regard to any reduction specified in subsection (c).

(B) *Loss for Taxable Year Beginning After 1949.*—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for the preceding taxable year.

* * * * *

(d) *Exceptions, Additions, and Limitations.*—The exceptions, additions, and limitations referred to in subsections (a) (b), and (c) shall be as follows:

* * * * *

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions, additions, and limitations specified in paragraphs (1) to (4) of this subsection.

* * * * *

(26 U.S.C. 1952 ed., Sec. 122.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.122-3. *Computation of Net Operating Loss in Case of a Taxpayer Other Than a Corporation.*—(a) *General.*—A net operating loss is sustained by a taxpayer other than a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions and limitations:
>
> * * * * *
>
> (7) Ordinary nonbusiness deductions (i.e., exclusive of capital losses) shall be allowed only to the extent of the amount of ordinary nonbusiness gross income (i.e., exclusive of capital gains), plus (A) for any taxable year beginning after December 31, 1938, and before January 1, 1942, the excess, if any, of nonbusiness long-term and short-term capital gains over nonbusiness long-term and short-term capital losses, respectively, and (B) for any taxable year beginning after December 31, 1941, the excess, if any, of nonbusiness capital gains over nonbusiness capital losses.
>
> * * * * *

STATEMENT

The findings of facts in the cases at bar (R. 25-29) were based on the stipulated facts contained in the pretrial order (R. 14-24), where both actions were consolidated for trial (R. 15.) The facts may be summarized as follows:

The taxpayers, L. H. Pierce and Lena L. Pierce, are husband and wife who filed separate individual income

tax returns for the years in question, 1946 and 1948. Taxpayers were residents of Multnomah County, Oregon, and in accordance with the community property law of that state each taxpayer reported one-half of this total income as his or her individual share of the community property. (R. 25-26, 28.)

Both taxpayers kept their books and filed their returns on a calendar year and cash receipts and disbursement basis. For taxable year 1946 the taxpayer husband had gross income of $66,662.26 and net income of $65,790.16. For the same year the taxpayer wife had gross income of $66,662.25 and net income of $65,825.45. Both taxpayers filed their separate 1946 returns with the Collector of Internal Revenue, Portland, Oregon, on or about March 15, 1947, in the amount of $36,456.66 for the husband and $36,112.31 for the wife which each paid to the Collector. (R. 26-27.)

The taxpayers were equal partners in the L. H. Pierce Auto Service which was organized on January 1, 1935. Taxpayers shared profits and losses equally for taxable years 1935 through 1948, inclusive. Taxpayers each owned 50% of the issued and outstanding stock of the Pierce Trailer & Equipment Company, an Oregon corporation, organized on or about April 2, 1947. The partnership had engaged in the manufacture of trailers until the corporation was organized, at which time the latter organization conducted the trailer business. The partnership then leased property it owned to the corporation and conducted other operations not connected with the business of the corporation. (R. 27-28.)

For the taxable year 1948 the taxpayers had income and losses as follows: The partnership, L. H. Pierce Auto Service, sustained a net operating loss of $4,193.12 reported as $2,096.56 by each taxpayer on his or her separate 1948 federal income tax return; the corporation, Pierce Trailer & Equipment Company, paid the taxpayer husband $6,000 for his services as president, which was reported as $3,000 on the separate 1948 federal income tax return by each taxpayer; each taxpayer deducted $3,391.47 on his or her separate 1948 tax return for his or her share of a nonbusiness casualty loss. (R. 28-29.)

On June 7, 1949, each taxpayer filed a separate claim for refund of taxes paid in 1946 in the amount of $1,-553.55 with the Collector of Internal Revenue, Portland, Oregon. The claims were based upon an alleged overpayment in 1946 assertedly due to a net operating loss carry-back from 1948 in the amount of $2,096.56 in each case resulting from the operation of the partnership. (R. 29.) The court below concluded that the taxpayer wife was entitled to the carry-back and relief in the full amount of her claim, and the taxpayer husband was not entitled to the carry-back and any relief upon his claim. (R. 29-31.) Judgments were rendered accordingly (R. 31-33), and these cross appeals followed.

STATEMENT OF POINTS TO BE URGED

The points to be urged by the United States in its appeal from the judgment in favor of the wife, Lena L. Pierce, are as follows:

1. The District Court erred in holding that where the activities of her husband in 1948 were sufficient to constitute the operation of a trade or business and where, under the community property law of Oregon, one-half of the income attributable to the operation of such trade or business was reported by taxpayer wife on her 1948 individual federal income tax return, that such income did not constitute trade or business income to taxpayer wife.

2. The District Court erred in holding that taxpayer wife, in the computation of the net operating loss deduction under Section 122(a) and (d)(5) of the Internal Revenue Code of 1939 for the year 1946, was entitled to treat as nonbusiness income the amount reported by her in 1948 which was attributable to the activities of her husband in the operation of a trade or business.

3. The District Court erred in holding that taxpayer wife was entitled to a deduction for the year 1946 under Section 23(s) of the Internal Revenue Code of 1939 in the amount of $2,096.56 as a net operating loss carry-back from the year 1948.

SUMMARY OF ARGUMENT

The taxpayers, husband and wife, filed separate income tax returns for the year 1948 and under the community property law of Oregon she reported one-half of the items here in issue as her share of the community property. In that year they equally incurred a nonbusiness casualty loss and a business net operating loss from

a partnership they owned equally. In addition, the husband received salary for services performed as a corporate official in a corporation they owned equally. Taxpayers claimed a net operating loss deduction by carrying back the loss on the partnership to year 1946. They claimed that the salary was not income received from a business or trade and could therefore be offset against the nonbusiness casualty loss under Section 122(d)(5) of the Internal Revenue Code of 1939. The Government urged that salary income is income from a trade or business and under Section 122(d)(5) could not be offset by the nonbusiness casualty loss. The District Court held that the husband's share of his salary income was income from his trade or business; however, the wife's share of her spouse's salary was not income from trade or business.

On taxpayer husband's appeal, the Government contends that the District Court was correct in holding salary income to be income from a trade or business under the governing provisions of the Code. This precise issue has been recently decided in the affirmative by the Courts of Appeals for the Second and Third Circuits in addition to the Tax Court in construing Section 122 (d)(5). Furthermore, any other decision would frustrate the intent of Congress.

On its appeal the Government urges that the District Court erred in holding the wife's share of her husband's business income as community property was not also business income to her. The Government contends that under the community property law the nature of the income is determined by activities of the spouse per-

forming the service. Since the District Court decided the salary was income from a trade or business in the hands of the husband, it is the same in the hands of the wife. This position finds ample support in the authorities.

ARGUMENT

I

Salary Income Received by Taxpayer for His Services as a Corporate Official Represents Income Attributable to the Operation of a Trade or Business Regularly Carried on by Him for Purposes of Computing the Net Operating Loss Deduction Within the Meaning of Section 122(d)(5) of the Internal Revenue Code of 1939

The instant cases have been consolidated for submission to this Court. In the court below the taxpayer wife prevailed in her suit for refund of taxes paid in 1946, and the Government prevailed in the taxpayer husband's suit for refund of taxes paid in the same year. The losing party in each suit has appealed the decision of the lower court. In addition to the stipulation as to consolidation of the two cases for appeal, the parties have also stipulated that the Government would present the first brief to this Court. (R. 31-33, 34-35, 43-44.)

The facts in these cases are not in controversy. (R. 21, 25.) The District Court's findings of fact were derived from a pre-trial order that was based upon facts stipulated by the parties. (R. 14-21, 25-29.) Consequently, the questions presented to this Court are legal issues.

The taxpayers in the cases at bar are husband and wife residing in the State of Oregon. In accordance with the community property provisions of that state, the husband and wife have each reported for income tax purposes one-half of the total income of the spouses as his or her share of the community property for the years in question. The taxpayers were equal partners in a business engaged mainly in trailer manufacturing known as L. H. Pierce Auto Service. They each also owned 50% of the total issued and outstanding stock of the Pierce Trailer & Equipment Company, Inc., an organization formed in April, 1947, that supplanted the partnership in the trailer business activities. Thereafter, the partnership conducted business operations not connected with the activities of the corporation although it did lease property to the latter organization. (R. 25-28.)

In the taxable year 1946 the husband had reported on federal income tax return a gross income of $66,662.26 upon which he paid a tax of $36,456.66 and the wife had reported gross income of $66,662.25 upon which she paid income tax in the amount of $36,112.31. (R. 26-27.) During the taxable year 1948 the partnership had a net operating loss of $4,193.12, each taxpayer reporting $2,096.56 on his respective tax return for that year. In addition, the husband as its president received a salary of $6,000 from the corporation which each taxpayer reported as $3,000 on the 1948 return. Further, each taxpayer incurred and separately reported the amount of $3,391.47 as a nonbusiness casualty loss on the same returns (R. 28-29.)

Taxpayers based their claims for refund on the provisions relating to net operating loss deductions as set forth in Sections 23(s) and 122 of the Internal Revenue Code of 1939, *supra*. Taxpayers had sought to avail themselves of the provision allowing a net operating loss carry-back. Specifically they claimed that their net operating loss of the partnership in 1948 should be offset against the 1946 income, thereby reducing the tax paid for the earlier year. Section 122(d)(5) of the Internal Revenue Code of 1939, *supra,* allows a taxpayer (other than a corporation), to make use of nonbusiness losses as a net operating loss carry-back only to the extent of his gross income in the same year not derived "from the operation of a trade or business regularly carried on by the taxpayer." It is admitted (R. 19) and the court below found (R. 28-29) that the casualty loss sustained in 1948 by each of the taxpayers in the amount of $3,391.47 was a nonbusiness casualty loss. Hence, for purposes of computation of a net operating loss, it could be utilized within the mandate of Section 122(d)(5) only to the extent of gross income not attributable to the operation of a trade or business regularly carried on by taxpayer. Taxpayers' contention is that the salary which taxpayer husband, L. H. Pierce, received as president of the corporation, Pierce Trailer & Equipment Company, Inc., was not derived from trade or business and, hence, the casualty loss was allowable under Section 122(d)(5) as against the amount of $3,000, or one-half of this salary reported by each of the respective taxpayers. This would leave the partnership loss, as a business loss, reported by each in the amount of $2,096.56 to be carried back as a net operating loss.

On the other hand, if, as the Government contends to be correct, the $3,000 of salary income reported by each taxpayer is income attributable to the operation of a trade or business then the amount of the nonbusiness casualty loss cannot be set off against it in computation of the net operating loss and cannot be used in computation of the net operating loss of either taxpayer. Moreover, if the Government's contention is correct, it further follows that there is no net operating loss at all to be carried back in the case of either taxpayer, since the partnership loss is less than the $3,000 business income, inuring to each member of the marital community, from the $6,000 salary paid to the taxpayer husband.

In the case of taxpayer husband the District Court agreed with the Government's contention and decided that, in the computation of the net operating loss deduction under Section 122 of the 1939 Code, the $3,000 received and reported by him from the corporation was received by him in the operation of a trade or business and must be offset against his distributable share of the partnership loss in the amount of $2,096.56 and, accordingly, held taxpayer husband is not entitled to any net operating loss deduction for 1946 and his complaint must be dismissed. (R. 29-30.) On this issue the taxpayer husband has appealed to this Court. On the other hand the District Court also held that $3,000 reported by the wife under the Oregon community property law, representing one-half of the salary paid by the corporation for his services as president (R. 30), "did not constitute income to her from her trade or business." Consequently, the lower court held this amount could be

offset against the nonbusiness casualty loss with the further result that her share of the $2,096.56 partnership loss for 1948 could be carried back as a net operating loss to 1946 and offset against her 1946 income. (R. 30-31.) The Government disputes this conclusion and, accordingly, has appealed the judgment in taxpayer wife's favor ($1,553.55 plus interest) based upon it. (R. 32-35.)

The Government respectfully submits that the court below was correct in holding that the salary received by taxpayer husband for services rendered as president of the corporation was income received in the operation of a trade or business within the meaning of Section 122 (d)(5).

The District Court's ruling in this connection in construction of Section 122(d)(5) is sustained by recent decisions of the Second and Third Circuits and the Tax Court which hold that a corporate officer or other employee who receives compensation in the form of a salary is engaged in a trade or business, namely, the trade or business of rendering services for pay. Therefore his salary is business income, and he may not deduct from it a nonbusiness loss in computing under Section 122 (d)(5) his net operating loss. *Overly* v. *Commissioner* (C.A. 3d), decided April 29, 1957 (1957 P-H, par. 72, 677); *Folker* v. *Johnson,* 230 F. 2d 906 (C.A. 2d); *Lagreide* v. *Commissioner,* 23 T.C. 508, overruling *Luton* v. *Commissioner,* 18 T.C. 1153;[1] *Wile* v. *Commissioner,* decided April 17, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,090); *Ranson* v. *Commissioner,* de-

[1] See, also, Rev. Rul. 55-600, 1955-2 Cum. Bull. 576.

cided June 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,213).

In holding salary to be income from a "trade or business regularly carried on by the taxpayer" the court reasoned in *Folker* v. *Johnson, supra* (pp. 908-909) as follows:

> * * * where the purpose of the two statutory provisions is similar a consistent interpretation is desirable and equitable. In this instance we think a consistent interpretation is necessary in order to fully effectuate the not dissimilar purposes of both sections. It should be noted that the net operating loss defined in Section 122 is utilized in the statutory scheme by taking a deduction as provided in the deduction section of the Code, Section 23(s).
>
> Salaried employees and corporate officers have been held to have been engaged in a trade or business under Section 23(a) on innumerable occasions.
>
> * * *
>
> * * * the corporation is an entity separate and apart from its officers and stockholders, and that its business is not the business of the officers.
>
> Consequently, we hold that the plaintiff, who devoted his entire working time to his duties as a corporate officer and who received compensation in the form of a salary, was engaged in a trade or business—the trade or business of rendering services for pay. Therefore, his salary was business income, and he may not deduct from it non-business expenses in computing under Section 122(d)(5) his net operating loss for carry-back purposes.

As many of the cited cases have recognized, salaried employees and corporate executives have repeatedly been held to have been engaged in a trade or business within the meaning of Section 23(a) of the 1939 Code.

Daily Journal Co. v. *Commissioner,* 135 F. 2d 687 (C.A. 9th); *Hill* v. *Commissioner,* 181 F. 2d 906 (C.A. 4th); *Hochschild* v. *Commissioner,* 161 F. 2d 817 (C.A. 2d); *Marsch* v. *Commissioner,* 110 F. 2d 423 (C.A. 7th); *Washburn* v. *Commissioner,* 51 F. 2d 949 (C.A. 8th). Substantially the same language contained in Section 122(d)(5) should be afforded the same meaning.

Cases which deny attempted deductions by corporate officers and stockholders of losses resulting from isolated loans to or investments in corporations in which they have a financial interest are not in point. They hold only that a taxpayer to sustain such a claimed deduction must show that it occurred in a separate business of his own; it is not enough for him to show that the loss occurred in the business of the corporation.[2] Indeed, as the Second Circuit pointed out in the *Folker* case, these authorities support the Government's position rather than that of the taxpayer, since they indicate that the corporation is an entity separate and apart from its officers and its stockholders and its business is not the business of its officers.

Moreover, the construction afforded Section 122(d) (5) by the District Court carries out the general purpose of the net operating loss deduction. Both the Senate and the House pointed out that the general purpose of the net operating loss provision was to equalize taxes. See S. Rep. No. 648, 76th Cong., 1st Sess., p. 1 (1939-2 Cum. Bull. 524); H. Rep. No. 855, 76th Cong., 1st Sess.,

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[2] *Dalton v. Bowers,* 287 U.S. 404; *Burnet v. Clark,* 287 U.S. 410; Miller v. Commissioner, 102 F. 2d 476 (C.A. 9th).

p. 9 (1939-2 Cum. Bull. 504, 510). In view of this policy a narrow interpretation of the clause "trade or business" in the net operating loss provision would leave a taxpayer earning net income from his salary in an inequitable position, for, as the court pointed out in the *Folker* case, *supra* (p. 908), it would be inequitable to interpret the phrase "trade or business" in such a fashion that salaried employees, professional men and others would not be dealt with under Section 122 in the same manner as persons receiving income from a sole proprietorship.

On the other hand the net operating loss deduction is particularly concerned with losses resulting from business operations and, hence, Congress limited the deduction in Section 122(d)(5) by providing that deductions otherwise allowed by law, but not attributable to the operation of a trade or business, should be allowed only to offset income which was not connected with business activities.

The decision of this Court in *McGinn* v. *Commissioner,* 76 F. 2d 680 (1935), construed language of earlier Revenue Acts dealing with net losses and in particular Section 204(a) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which defined net loss to be "only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer." Taxpayer was a corporate officer of a bank and the loss occurred (p. 681) "because as such officer of the bank he disposed of the property of the bank in violation of the law and was compelled to reimburse the bank for the loss." This Court held this loss was not deductible as a net loss, since not resulting from the operation of any trade or

business regularly carried on by the taxpayer. This holding may be distinguishable from the case at bar on the ground that the loss there was not proximately related to the occupation of being a corporate officer, but occurred rather in the separate business of the corporation itself. Taxpayer, having caused the loss in the corporate business, was required to make it good. Moreover, the Court there cited *Dalton* v. *Bowers, supra,* and *Burnet* v. *Clark, supra,* and the accepted reading of those cases today, discussed above, namely, that they involved isolated loans to and investments in corporations, not amounting to a trade or business, may not have been as plain twenty-two years ago. Nevertheless, some of the language contained in the opinion in the *McGinn* case is inconsistent with the recent holdings of the Second and Third Circuits and of the Tax Court, cited above, and to that extent, it is respectfully requested that this Court adopt the reasoning of these recent cases[3] and which inferentially the court below felt it was not inhibited by any decision of this Court from adopting.

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[3] See comment on the *McGinn* case by the Second Circuit in the *Folker* case (p. 908) and on *Hughes v. Commissioner,* 38 F. 2d 755 (C.A. 10th) (1930), by the Third Circuit in the *Overly* case, *supra,* and the Second Circuit in the *Folker* case (p. 908).

II

Under Community Property Law the Nature of Income Reported Separately by a Husband and Wife Is Determined for Both as Attributable to the Operations of a Trade or Business by the Activities of the Husband, Who Produced the Income

The District Court concluded in regard to the taxpayer wife that the $3,000 reported by her under the community property law of Oregon on her 1948 federal income tax return which represented one-half of the salary paid to her husband did not constitute income to her from her trade or business. (R. 30.) Consequently, the wife was allowed to offset her share of the husband's salary against the nonbusiness casualty loss and therefore carry back to 1946 her share of the partnership net operating loss of 1948. The Government respectfully urges that the court below erred in arriving at this conclusion of law. The Government contends that in a community property jurisdiction the nature of the income—that is, whether it is or is not income from a trade or business—is determined by the activities of the spouse who produced the income.

The Oregon Community Property Act under which the husband and wife taxpayers filed their separate 1948 tax returns (R. 25) was put into effect on July 5, 1947, and was repealed on April 11, 1949, and thus was in force during 1948. (Oregon Laws of 1947, c. 525; Oregon Laws of 1949, c. 349.) It is not disputed that the community property system was imposed on married persons, such as these taxpayers, domiciled in Oregon during 1948. I.T. 3868, 1947-2 Cum. Bull. 49.

It had long been recognized that the community property relation between husband and wife created a situation in which the spouse earning the income acted as an agent for the community. *Poe* v. *Seaborn,* 282 U.S. 101. Another explanation of the community property relation is that it is a partnership with each spouse having equal rights in the property and the income of that property. *Goodell* v. *Koch,* 282 U.S. 118; *Bender* v. *Pfaff,* 282 U.S. 127. The rights of one spouse in the community property is perfectly equivalent to the rights of the other spouse. *Hopkins* v. *Bacon,* 282 U.S. 112. Recognizing the legal effect of the community property relationship, it cannot be said that the spouse earning the income for the community has income of a different nature than the other spouse. The nature of the income for both members of the partnership is determined when the income is earned.

A striking analogy is presented by authority holding that where a spouse earned income that was tax exempt the community share reported by his spouse was also exempt from taxation. This situation is made very clear in *Kaufman* v. *Commissioner,* 9 B.T.A. 1180. In that case the husband was employed by the State of Louisiana, a community property state. Income of that nature was then exempt from federal income taxation under the Revenue Act of 1921, c. 136, 42 Stat. 227. The Commissioner attempted to tax one-half of this income, being the wife's share of the community, on the basis that since the wife was not employed by the State the income lost its exempt status in the hands of the wife.

The Board of Tax Appeals (now the Tax Court) answered this contention as follows (p. 1182):

> This contention is based upon an erroneous conception of community income. The earnings of the husband from personal services become immediately a part of the community. Any exemption from taxation in relation to those earnings immediately attaches to the total amount, and whatever right the wife may have to report one-half thereof can not affect its taxable status and convert into taxable income that which was exempt when it came into the community.

Other authorities illustrating that the division of income on the community property basis does not alter the exempt character of income entitled to exemption are: *Markham* v. *United States* (S.D. Calif.), decided June 23, 1953 (45 A.F.T.R. 1143); *Mullen* v. *Commissioner,* 14 T.C. 1179; I.T. 3665, 1944-1 Cum. Bull. 161; Rev. Rul. 54-16, 1954-1 Cum. Bull. 157; Rev. Rul. 55-246, 1955-1Cum. Bull. 92.

This Court has already decided whether or not the nature of the income in the hands of the spouse reporting her share under the community property system is any different than that in the hands of the spouse whose activities earned the income. In *Graham* v. *Commissioner,* 95 F. 2d 174, this Court was faced with the question of whether the wife's half of the community income derived from the husband's architectural fees was "Earned income" within the meaning of Section 31 of the Revenue Act of 1928, c. 852, 45 Stat. 791. This section allowed a taxpayer a credit for a percentage of his "Earned income" which in this specific case would be professional fees received as compensation for personal

services actually rendered. The Government conceded that the husband's share of the income earned for the community was "Earned income" but it contended that the wife's share was not because she did not actually render any personal services.[4]

This Court rejected the Government's contention and held (p. 176):

> The Board found that said community income was received as compensation for professional services rendered by petitioner's husband. Respondent assumes, erroneously, that these services were rendered by petitioner's husband individually, on his own account and for himself alone, thus assuming as a fact that which, in Washington, is a legal impossibility. When a married man residing in Washington practices a profession or engages in any gainful occupation or activity, he does so as the agent of a marital community consisting of himself and his wife. *Poe* v. *Seaborn, supra*. He cannot do so in any other way or in any other capacity. *Services rendered by him are actually rendered by the community, that is to say, by him and his wife, equally. So, in this case, petitioner was, no less than her husband, the actual renderer of the services for which they received as compensation the community income above referred to.*
>
> *That petitioner did not personally participate in the professional labors of her husband is immaterial. One may actually render a personal service without personally performing the acts constituting the service.* Otherwise a partnership acting through one of its members, or a principal acting through an agent, could not actually render a personal service, the truth being, of course, that such services can be

[4] A case in another circuit with facts similar to the *Graham* case, *supra*, and arriving at the same decision, is *McLarry v. Commissioner*, 30 F. 2d 789 (C.A. 5th).

> and, in countless instances, are actually so rendered. (Italics supplied.)

The reasoning of this Court is equally applicable to the cases at bar. Taxpayer husband received income for his services that was income of the community of which he was an agent. The nature of the income of the community was determined when it was earned. Consequently, if the lower court is sustained on Point I, *supra,* that salary income of taxpayer husband is income from a trade or business it follows that the entire salary income earned for the community is income from a trade or business. The income in the hands of the wife representing her share of the community property is determined by the activities of the husband who produced the income. It is all business income.

CONCLUSION

For the reasons above given the judgment of the District Court for the defendant and dismissing the complaint should be affirmed in the case of taxpayer husband *(L. H. Pierce* v. *United States),* and the judgment of the District Court against the defendant in the sum of $1,553.55 with interest should be reversed and judgment directed for the defendant and the complaint dismissed in the case of the taxpayer wife on the Government's appeal *(United States* v. *Lena L. Pierce).*

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.
JOHN N. STULL,
I. HENRY KUTZ,
ARTHUR I. GOULD,
Attorneys,
Department of Justice,
Washington 25, D.C.

CLARENCE E. LUCKEY,
United States Attorney.
EDWARD J. GEORGEFF,
Assistant United States Attorney.

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